

Proposed Rule Change by National Association of Securities Dealers
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

<input type="checkbox"/> Initial	<input checked="" type="checkbox"/> Amendment	<input type="checkbox"/> Withdrawal	<input checked="" type="checkbox"/> Section 19(b)(2)	<input type="checkbox"/> Section 19(b)(3)(A)	<input type="checkbox"/> Section 19(b)(3)(B)
			Rule		
<input type="checkbox"/> Pilot	<input type="checkbox"/> Extension of Time Period for Commission Action	<input type="text" value=""/> Date Expires	<input type="checkbox"/> 19b-4(f)(1)	<input type="checkbox"/> 19b-4(f)(4)	
			<input type="checkbox"/> 19b-4(f)(2)	<input type="checkbox"/> 19b-4(f)(5)	
			<input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(6)	

<input type="checkbox"/> Exhibit 2 Sent As Paper Document	<input type="checkbox"/> Exhibit 3 Sent As Paper Document
---	---

Description
Provide a brief description of the proposed rule change (limit 250 characters).

Contact Information
Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name	<input type="text" value="Kathleen"/>	Last Name	<input type="text" value="O'Mara"/>
Title	<input type="text" value="Associate General Counsel"/>		
E-mail	<input type="text" value="kathleen.omara@nasd.com"/>		
Telephone	<input type="text" value="(202) 728-8056"/>	Fax	<input type="text" value="(202) 728-8264"/>

Signature
Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date	<input type="text" value="02/09/2005"/>
By	<input type="text" value="Patrice M. Gliniecki"/>
	(Name)
	<input type="text" value="Senior Vice President and Deputy General Counsel"/>
	(Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information

[Add](#) [Remove](#) [View](#)

The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change

[Add](#) [Remove](#) [View](#)

The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

[Add](#) [Remove](#) [View](#)

Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit 3 - Form, Report, or Questionnaire

[Add](#) [Remove](#) [View](#)

Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit 4 - Marked Copies

[Add](#) [Remove](#) [View](#)

The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

[Add](#) [Remove](#) [View](#)

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

[Add](#) [Remove](#) [View](#)

If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend NASD Rule 2320(a) (“Best Execution Rule”). This rule filing replaces and supersedes, in its entirety, Amendment No. 1 filed with the SEC on May 11, 2004. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2300. TRANSACTIONS WITH CUSTOMERS

* * * * *

2320. Best Execution and Interpositioning

(a) In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best [inter-dealer] market center for the subject security and buy or sell in such market center so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

- (1) [T]he character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;
- (2) the size and type of transaction;
- (3) the number of [primary] market[s] centers checked;

(4) accessibility of the quotation [location and accessibility to the customer's broker/dealer of primary markets and quotations sources.]; and

(5) the terms and conditions of the order which result in the transaction,
as communicated to the member and persons associated with the member.

(b) through (g) No change.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The proposed rule change was originally approved by the Board of Directors of NASD Regulation, Inc. at its meeting on November 12, 2003, which authorized the filing of the rule change with the SEC. The NASD Board of Governors reviewed the proposed rule change originally at its meeting on November 13, 2003. This amendment to the proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on November 17, 2004, which authorized the filing of the amendment with the SEC. The NASD Board of Governors reviewed the amendment to the proposed rule change at its meeting on November 18, 2004. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

The Best Execution Rule currently requires a member, in any transaction for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. NASD has received a number of questions regarding the application of the term “customer,” in the context of best execution. NASD Rule 0120(g) defines “customer” to exclude a broker or dealer, unless the context otherwise requires. For example, if a firm that receives an order from a customer (“originating broker-dealer”) routes the order to a member firm (“recipient member”) and the recipient member executes the order in a manner inconsistent with the Best Execution Rule, the recipient member could argue that it has not violated the Best Execution Rule because the transaction was not “for or with a customer,” but rather for or with a broker-dealer.

NASD believes that not applying the Best Execution Rule to recipient members is contrary to the interests of the investing public as well as the general intent of the Best Execution Rule. To determine whether the scope of the Best Execution Rule requires further clarification to include customer orders received by a member from another

broker-dealer, NASD issued Notice to Members 02-40 in July 2002 seeking comment on this issue. NASD received eleven comment letters in response to the Notice.¹ The majority of the commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker-dealer.

On February 11, 2004, NASD submitted to the SEC rule filing SR-NASD-2004-026 requiring that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer orders. The proposal also sought to clarify that the recipient member was not required to enter into any such written agreements with the originating broker-dealer, and that the originating broker-dealer (to the extent it is was a member) would remain obligated to comply with the Best Execution Rule, irrespective of whether such an agreement existed.

On May 11, 2004, NASD submitted to the SEC Amendment No. 1 to SR-NASD-2004-026, which replaced and superceded, in its entirety, the original filing. Amendment No. 1 continued to require that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating

¹ Letter from Dan Jamieson dated July 18, 2002; Letter from Seidel & Shaw, LLC dated July 29, 2002; Letter from Consolidated Financial Investments, Inc. dated Aug. 1, 2002; Letter from the Law Offices of Steve A. Buchwalter, P.C. dated Aug. 6, 2002; Letter from A.G. Edwards & Sons, Inc. dated Aug. 8, 2002; Letter from Raymond James & Associates, Inc. dated Aug. 8, 2002; Letter from T. Rowe Price Investment Services, Inc. dated Aug. 8, 2002; Letter from Security Traders Association dated Aug. 22, 2002; Letter from The Island ECN, Inc. dated Aug. 22, 2002; Letter from the Trading Committee and the Self-Regulation and Supervisory Practices Committee of the Securities Industry Association dated Sept. 9, 2002; and Letter from the Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association dated Oct. 2, 2002.

broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer orders. In addition, Amendment No. 1 added a new reasonable diligence factor to the text of the Best Execution Rule that required consideration of the existence of a written agreement or written representations when a customer order is routed to another broker-dealer. Also, the amendment modified the text of new proposed paragraph (a)(2) of the Best Execution Rule. Lastly, the amendment provided proposed interpretive guidance concerning Rule 2320, as amended.

Proposal

NASD is proposing to amend the Best Execution Rule with this Amendment No. 2 to require that a recipient member provide best execution to all transactions for or with a customer of another broker-dealer. Specifically, NASD is proposing to amend the Best Execution Rule to state that the rule governs "any transaction for or with a customer or a customer of another broker-dealer." NASD believes this proposed rule change will better ensure customer orders receive the equivalent best execution protections. This will occur without regard to whether a customer order is executed by the originating broker-dealer or routed to another broker-dealer.² Moreover, the best execution protection will apply whether the originating or recipient member executes the order as principal or routes it as agent to another market center. The recipient firm's duty under the rule is owed only to orders accepted by the recipient firm. The proposed rule change will enhance NASD's

² It is NASD staff's belief that this approach is preferable to that specified in the original rule proposal and Amendment No. 1 because customer orders will receive best execution protections without regard to whether there is a written agreement or written representations from a recipient member.

regulatory program and create a more uniform and consistent standard of best execution than currently exists.³

Furthermore, NASD is amending the Best Execution Rule to modernize the text of the rule. The Best Execution Rule currently requires a member to ascertain the best “inter-dealer” market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. As a result of changes in market structure, NASD is proposing to delete the term “inter-dealer” from Rule 2320(a). This amendment will clarify that member requirements to ascertain the best market for a security are not limited to “inter-dealer” markets, but may include all “market centers” in which a security is traded. NASD also is amending the reasonable diligence factors to reflect current market structure and to delete terms that are outdated. Specifically, NASD is recommending that the reference to the “number of primary markets checked” be updated to instead refer to “the number of market centers checked” and that the reference to the “location and accessibility to the customer’s broker-dealer of primary markets and quotation sources” be updated to emphasize the importance of “accessibility of the quotation.” Lastly, NASD proposes adding a new factor that examines the “terms and conditions of the order” in determining whether a member has used due diligence. This will allow NASD staff to consider the communication of a

³ We note that by extending the scope of the Best Execution Rule to customer orders of another broker-dealer, the proposed rule change does not alter the obligation of an originating broker-dealer member to examine regularly and rigorously execution quality likely to be obtained from different market centers trading a security. See Notice to Members 01-22 (April 2001), that reiterates the best execution obligations that apply to member firms when they receive, handle, route for execution, or execute customer orders, and that also provides guidance to members concerning a broker-dealer’s obligation, as articulated on numerous occasions by the SEC, to examine regularly and rigorously execution quality likely to be obtained from the different markets or market makers trading a security.

customer's instructions to assess whether a member and persons associated with a member have used "reasonable diligence."

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. Also in this Notice to Members, NASD will issue interpretive guidance consistent with the interpretive positions specified in this rule filing. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The obligation of a member firm to provide best execution to its customers has long been an important investor protection rule, characteristic of fair and orderly markets and a central focus of NASD's examination, customer complaint, and automated surveillance programs. NASD believes that the proposed rule change will expand customer protection under the Best Execution Rule, provide better clarity to members, and enhance NASD's ability to pursue actions for failure to provide best execution.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

As discussed in the Section 3(a) above, NASD published Notice to Members 02-40 (July 2002) seeking comment on whether the scope of the duty of best execution should be clarified to include customer orders received by a member from another broker-dealer. A copy of the Notice is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3.

Specifically, NASD solicited comment on several approaches, including whether the scope of the duty of best execution should be: (1) limited to customer orders where there is an agreement or arrangement between the two broker-dealers that the recipient broker-dealer would comply with the duty of best execution; (2) limited to customer orders routed pursuant to an arrangement or an agreement noted in NASD Notice to Members 02-40 (i.e., where a broker-dealer agrees to provide automated executions to a routing broker-dealer's customer orders or there is another arrangement between the two broker-dealers such as a payment for order flow, reciprocal, or correspondent arrangement); (3) limited to customer orders routed pursuant to an arrangement or an agreement where the recipient broker-dealer assesses a fee or charge to execute the order; (4) defined more broadly to include all orders that are identified by the routing broker-dealer as customer orders; or (5) clarified or amended in some other fashion. NASD also solicited comment on whether the Best Execution Rule should distinguish, if at all, between customer orders received by a member from a foreign affiliate or foreign broker-dealer (as opposed to customer orders received by a member from a domestic affiliate or domestic broker-dealer that is subject to SEC, NASD, or other legal obligations concerning best execution).

NASD received eleven comments in response to the Notice. Seven commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker-dealer.⁴ Three of the seven commenters asserting that the Best Execution Rule should be amended, believed that all routed orders should be treated by the receiving member as customer orders and, therefore, provided best execution. Two commenters thought that the Best Execution Rule should be amended to provide best execution protections specified by the Rule to all orders that are identified by the originating broker-dealer as customer orders. Lastly, two commenters articulated that the receiving broker-dealer should only have a duty of best execution under Rule 2320 when the receiving broker-dealer has explicitly agreed to handle orders received from the originating broker-dealer as customer orders.

Four commenters asserted that the Best Execution Rule should not be amended at all.⁵ In general, commenters that opposed amending the Best Execution Rule asserted that an amendment was unnecessary. Some of the reasons given for advocating for no change to the Best Execution Rule included assertions that a change could stifle competition, the costs associated with amending the Rule outweigh the benefits, and that such a proposal would raise concerns regarding customers' privacy interests. After considering the comments received in response to the Notice, NASD proposed amending the Best Execution Rule. On February 11, 2004, NASD submitted to the SEC rule filing

⁴ See letters from Dan Jamieson; Consolidated Financial Investments, Inc.; the Law Offices of Steve A. Buchwalter, P.C.; Raymond James & Associates, Inc.; T. Rowe Price Investment Services, Inc.; Security Traders Association; and The Island ECN, Inc.

⁵ See letters from Seidel & Shaw, LLC; A.G. Edwards & Sons, Inc.; the Securities Industry Association, Trading Committee and Self-Regulation and Supervisory Practices Committee; and the American Bar Association, Section of Business Law, Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities.

SR-NASD-2004-026. On May 11, 2004, NASD submitted to the SEC Amendment No. 1 to SR-NASD-2004-026, which replaced and superceded, in its entirety, the original filing.

In a letter dated August 17, 2004, the Securities Industry Association (SIA) through its Ad Hoc Best Execution Committee (SIA Committee) submitted comments to NASD in response to NASD's filing of Amendment No. 1 with the SEC.⁶ In this letter, the SIA Committee asserted that the proposal pending at the SEC is unnecessary in light of the effective safeguards already in place as a result of interplay between the current regulatory framework imposed on originating broker-dealers and competitive forces requiring recipient members to provide high-quality executions to orders routed to them. NASD staff did not agree with the SIA Committee's position that the current regulatory framework sufficiently addresses best execution obligations of recipient members. In addition, the SIA Committee urged NASD, to the extent that NASD is determined to amend the Best Execution Rule, to consider an alternative approach that would focus on extending the scope of the Rule to include transactions for or with a "customer of another broker-dealer." The SIA Committee's alternative approach is consistent with the approach NASD is proposing in this amendment.

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

⁶ Letter from Amal Aly and Ann Vlcek, on behalf of the Ad Hoc Best Execution Committee of the Securities Industry Association, to Barbara Z. Sweeney, NASD, dated Aug. 17, 2004.

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2. Letter from the Ad Hoc Best Execution Committee of the Securities Industry Association dated August 17, 2004.

Exhibit 4. Text of the rule change marked to indicate additions and deletions from the text as proposed in Amendment No. 1 on May 11, 2004.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2004-026)

SELF-REGULATORY ORGANIZATIONS

Proposed Rule Change by National Association of Securities Dealers, Inc. to Amend NASD's Best Execution Rule

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. ("NASD"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change and Amendment Nos. 1 and 2³ as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to amend Rule 2320(a) ("Best Execution Rule"). Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

2300. TRANSACTIONS WITH CUSTOMERS

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 to SR-NASD-2004-026 was filed with the SEC on May 11, 2004. This 19b-4 filing represents Amendment No. 2 and replaces and supercedes in their entirety both the original rule filing and Amendment No. 1.

* * * * *

2320. Best Execution and Interpositioning

(a) In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best [inter-dealer] market center for the subject security and buy or sell in such market center so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

- (1) [T]the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;
 - (2) the size and type of transaction;
 - (3) the number of [primary] market[s] centers checked;
 - (4) accessibility of the quotation [location and accessibility to the customer’s broker/dealer of primary markets and quotations sources.]; and
 - (5) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.
- (b) through (g) No change.

* * * * *

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in

Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Background

The Best Execution Rule currently requires a member, in any transaction for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. NASD has received a number of questions regarding the application of the term “customer,” in the context of best execution. NASD Rule 0120(g) defines “customer” to exclude a broker or dealer, unless the context otherwise requires. For example, if a firm that receives an order from a customer (“originating broker-dealer”) routes the order to a member firm (“recipient member”) and the recipient member executes the order in a manner inconsistent with the Best Execution Rule, the recipient member could argue that it has not violated the Best Execution Rule because the transaction was not “for or with a customer,” but rather for or with a broker-dealer.

NASD believes that not applying the Best Execution Rule to recipient members is contrary to the interests of the investing public as well as the general intent of the Best Execution Rule. To determine whether the scope of the Best Execution Rule requires further clarification to include customer orders received by a member from another broker-dealer, NASD issued Notice to Members 02-40 in July 2002 seeking comment on

this issue. NASD received eleven comment letters in response to the Notice.⁴ The majority of the commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty with respect to customer orders received from another broker-dealer.

On February 11, 2004, NASD submitted to the SEC rule filing SR-NASD-2004-026 requiring that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer orders. The proposal also sought to clarify that the recipient member was not required to enter into any such written agreements with the originating broker-dealer, and that the originating broker-dealer (to the extent it is was a member) would remain obligated to comply with the Best Execution Rule, irrespective of whether such an agreement existed.

On May 11, 2004, NASD submitted to the SEC Amendment No. 1 to SR-NASD-2004-026, which replaced and superceded, in its entirety, the original filing. Amendment No. 1 continued to require that a recipient member provide best execution to customer orders routed to it when there was either a written agreement between the originating broker-dealer and the recipient member or written representations from the recipient member that it would provide best execution to the originating broker-dealer's customer

⁴ Letter from Dan Jamieson dated July 18, 2002; Letter from Seidel & Shaw, LLC dated July 29, 2002; Letter from Consolidated Financial Investments, Inc. dated Aug. 1, 2002; Letter from the Law Offices of Steve A. Buchwalter, P.C. dated Aug. 6, 2002; Letter from A.G. Edwards & Sons, Inc. dated Aug. 8, 2002; Letter from Raymond James & Associates, Inc. dated Aug. 8, 2002; Letter from T. Rowe Price Investment Services, Inc. dated Aug. 8, 2002; Letter from Security Traders Association dated Aug. 22, 2002; Letter from The Island ECN, Inc. dated Aug. 22, 2002; Letter from the Trading Committee and the Self-Regulation and Supervisory Practices Committee of the Securities Industry Association dated Sept. 9, 2002; and Letter from the Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association dated Oct. 2, 2002.

orders. In addition, Amendment No. 1 added a new reasonable diligence factor to the text of the Best Execution Rule that required consideration of the existence of a written agreement or written representations when a customer order is routed to another broker-dealer. Also, the amendment modified the text of new proposed paragraph (a)(2) of the Best Execution Rule. Lastly, the amendment provided proposed interpretive guidance concerning Rule 2320, as amended.

Proposal

NASD is proposing to amend the Best Execution Rule with this Amendment No. 2 to require that a recipient member provide best execution to all transactions for or with a customer of another broker-dealer. Specifically, NASD is proposing to amend the Best Execution Rule to state that the rule governs “any transaction for or with a customer or a customer of another broker-dealer.” NASD believes this proposed rule change will better ensure customer orders receive the equivalent best execution protections. This will occur without regard to whether a customer order is executed by the originating broker-dealer or routed to another broker-dealer.⁵ Moreover, the best execution protection will apply whether the originating or recipient member executes the order as principal or routes it as agent to another market center. The recipient firm's duty under the rule is owed only to orders accepted by the recipient firm. The proposed rule change will enhance NASD's regulatory program and create a more uniform and consistent standard of best execution than currently exists.⁶

⁵ It is NASD staff's belief that this approach is preferable to that specified in the original rule proposal and Amendment No. 1 because customer orders will receive best execution protections without regard to whether there is a written agreement or written representations from a recipient member.

⁶ We note that by extending the scope of the Best Execution Rule to customer orders of another broker-dealer, the proposed rule change does not alter the obligation of an originating broker-

Furthermore, NASD is amending the Best Execution Rule to modernize the text of the rule. The Best Execution Rule currently requires a member to ascertain the best “inter-dealer” market for a security and to buy or sell in such a market so that the price to the customer is as favorable as possible under the prevailing market conditions. As a result of changes in market structure, NASD is proposing to delete the term “inter-dealer” from Rule 2320(a). This amendment will clarify that member requirements to ascertain the best market for a security are not limited to “inter-dealer” markets, but may include all “market centers” in which a security is traded. NASD also is amending the reasonable diligence factors to reflect current market structure and to delete terms that are outdated. Specifically, NASD is recommending that the reference to the “number of primary markets checked” be updated to instead refer to “the number of market centers checked” and that the reference to the “location and accessibility to the customer’s broker-dealer of primary markets and quotation sources” be updated to emphasize the importance of “accessibility of the quotation.” Lastly, NASD proposes adding a new factor that examines the “terms and conditions of the order” in determining whether a member has used due diligence. This will allow NASD staff to consider the communication of a customer’s instructions to assess whether a member and persons associated with a member have used “reasonable diligence.”

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. Also in

dealer member to examine regularly and rigorously execution quality likely to be obtained from different market centers trading a security. See Notice to Members 01-22 (April 2001), that reiterates the best execution obligations that apply to member firms when they receive, handle, route for execution, or execute customer orders, and that also provides guidance to members concerning a broker-dealer’s obligation, as articulated on numerous occasions by the SEC, to examine regularly and rigorously execution quality likely to be obtained from the different markets or market makers trading a security.

this Notice to Members, NASD will issue interpretive guidance consistent with the interpretive positions specified in this rule filing. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The obligation of a member firm to provide best execution to its customers has long been an important investor protection rule, characteristic of fair and orderly markets and a central focus of NASD's examination, customer complaint, and automated surveillance programs. NASD believes that the proposed rule change will expand customer protection under the Best Execution Rule, provide better clarity to members, and enhance NASD's ability to pursue actions for failure to provide best execution.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

As discussed in the Section 3(a) above, NASD published Notice to Members 02-40 (July 2002) seeking comment on whether the scope of the duty of best execution should be clarified to include customer orders received by a member from another

broker-dealer. A copy of the Notice is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3.

Specifically, NASD solicited comment on several approaches, including whether the scope of the duty of best execution should be: (1) limited to customer orders where there is an agreement or arrangement between the two broker-dealers that the recipient broker-dealer would comply with the duty of best execution; (2) limited to customer orders routed pursuant to an arrangement or an agreement noted in NASD Notice to Members 02-40 (i.e., where a broker-dealer agrees to provide automated executions to a routing broker-dealer's customer orders or there is another arrangement between the two broker-dealers such as a payment for order flow, reciprocal, or correspondent arrangement); (3) limited to customer orders routed pursuant to an arrangement or an agreement where the recipient broker-dealer assesses a fee or charge to execute the order; (4) defined more broadly to include all orders that are identified by the routing broker-dealer as customer orders; or (5) clarified or amended in some other fashion. NASD also solicited comment on whether the Best Execution Rule should distinguish, if at all, between customer orders received by a member from a foreign affiliate or foreign broker-dealer (as opposed to customer orders received by a member from a domestic affiliate or domestic broker-dealer that is subject to SEC, NASD, or other legal obligations concerning best execution).

NASD received eleven comments in response to the Notice. Seven commenters asserted that the Best Execution Rule should be amended to clarify the scope of the duty

with respect to customer orders received from another broker-dealer.⁷ Three of the seven commenters asserting that the Best Execution Rule should be amended, believed that all routed orders should be treated by the receiving member as customer orders and, therefore, provided best execution. Two commenters thought that the Best Execution Rule should be amended to provide best execution protections specified by the Rule to all orders that are identified by the originating broker-dealer as customer orders. Lastly, two commenters articulated that the receiving broker-dealer should only have a duty of best execution under Rule 2320 when the receiving broker-dealer has explicitly agreed to handle orders received from the originating broker-dealer as customer orders.

Four commenters asserted that the Best Execution Rule should not be amended at all.⁸ In general, commenters that opposed amending the Best Execution Rule asserted that an amendment was unnecessary. Some of the reasons given for advocating for no change to the Best Execution Rule included assertions that a change could stifle competition, the costs associated with amending the Rule outweigh the benefits, and that such a proposal would raise concerns regarding customers' privacy interests. After considering the comments received in response to the Notice, NASD proposed amending the Best Execution Rule. On February 11, 2004, NASD submitted to the SEC rule filing SR-NASD-2004-026. On May 11, 2004, NASD submitted to the SEC Amendment No. 1 to SR-NASD-2004-026, which replaced and superceded, in its entirety, the original filing.

⁷ See letters from Dan Jamieson; Consolidated Financial Investments, Inc.; the Law Offices of Steve A. Buchwalter, P.C.; Raymond James & Associates, Inc.; T. Rowe Price Investment Services, Inc.; Security Traders Association; and The Island ECN, Inc.

⁸ See letters from Seidel & Shaw, LLC; A.G. Edwards & Sons, Inc.; the Securities Industry Association, Trading Committee and Self-Regulation and Supervisory Practices Committee; and the American Bar Association, Section of Business Law, Subcommittee on Market Regulation of the Committee on Federal Regulation of Securities.

In a letter dated August 17, 2004, the Securities Industry Association (SIA) through its Ad Hoc Best Execution Committee (SIA Committee) submitted comments to NASD in response to NASD's filing of Amendment No. 1 with the SEC.⁹ In this letter, the SIA Committee asserted that the proposal pending at the SEC is unnecessary in light of the effective safeguards already in place as a result of interplay between the current regulatory framework imposed on originating broker-dealers and competitive forces requiring recipient members to provide high-quality executions to orders routed to them. NASD staff did not agree with the SIA Committee's position that the current regulatory framework sufficiently addresses best execution obligations of recipient members. In addition, the SIA Committee urged NASD, to the extent that NASD is determined to amend the Best Execution Rule, to consider an alternative approach that would focus on extending the scope of the Rule to include transactions for or with a "customer of another broker-dealer." The SIA Committee's alternative approach is consistent with the approach NASD is proposing in this amendment.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

⁹ Letter from Amal Aly and Ann Vlcek, on behalf of the Ad Hoc Best Execution Committee of the Securities Industry Association, to Barbara Z. Sweeney, NASD, dated Aug. 17, 2004.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2004-026 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2004-026. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street,

NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the File Number SR-NASD-2004-026 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Secretary

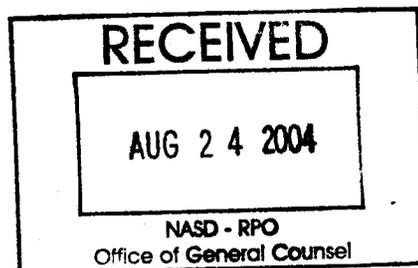
¹⁰ 17 CFR 200.30-3(a)(12).



Securities Industry Association

1425 K Street, NW • Washington, DC 20005-3500 • (202) 216-2000, Fax (202) 216-2119 • www.sia.com, info@sia.com

August 17, 2004



Ms. Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

Re: **SR-NASD-2004-026: Proposed Amendments to NASD Rule 2320(a), NASD's Best Execution Rule; Amendment No. 1**

Dear Ms. Sweeney:

The Ad Hoc Best Execution Committee (the "Committee") of the Securities Industry Association (the "SIA")¹ has reviewed the amendments to the National Association of Securities Dealers, Inc. ("NASD") Rule 2320(a) (the "Best Execution Rule") proposed in the above-referenced rule filing (the "Proposed Rule").² Given the important and potentially far-reaching implications of the Proposed Rule, SIA created this Committee several months ago to study the proposal. Members of the Committee met with representatives from the NASD General Counsel's office and Market Regulation Department on June 2, 2004 to discuss the Committee's concerns with the Proposed Rule. We very much appreciate the NASD staff's willingness to consider our views, and are submitting this letter to clarify our position further and to offer to work with the NASD to address its concerns in this area.

NASD states that this Proposed Rule is a result of the comments received on NASD Notice-to-Members 02-40 ("NTM 02-40"),³ in which they suggested certain amendments to the current Best Execution Rule. As discussed in more detail below, in September 2002 the SIA submitted a comment letter generally opposing the amendments

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$209 billion in U.S. revenue and \$278 billion in global revenues. (More information about the SIA is available on its home page: www.sia.com.)

² Members of the Committee began expressing concerns soon after the rule filing was posted to the NASD website in February 2004. On May 11, 2004, the NASD submitted Amendment No. 1 to the Securities and Exchange Commission ("SEC"). The SEC has not yet published the rule filing for comment.

³ See Notice To Members 02-40 available at www.nasdr.com/pdf-text/0240ntm.pdf.

proposed in NTM 02-40 (the "September 2002 Comment Letter").⁴ We share NASD's concerns about alleged trading abuses by certain market participants and wish to work with NASD to ensure that adequate safeguards are in place to combat such abuses. However, we feel it equally important to avoid regulation that, in the name of addressing these alleged abuses, misplaces the regulatory obligations of market participants. It is the routing broker-dealer that, by virtue of its relationship with the customer, can and should be responsible for determining and satisfying its customers' expectations for best execution. A regulatory framework that requires contractual best execution commitments from a recipient broker-dealer will not put that party in a position to adequately assess and provide best execution to those orders.

A. Overview

NTM 02-40 and the Proposed Rule generally address obligations of a member firm that receives customer orders for execution from another broker-dealer. As stated during our June 2 meeting, we agree with NASD that best execution obligations provide important protections to investors, and we believe it is important that NASD periodically review these and other existing regulatory requirements to ensure that investors continue to be afforded a high level of protection. The Committee, however, continues to believe in the principles stated in the SIA's September 2002 Comment Letter and, therefore, maintains that the current rule proposal is unnecessary in light of the effective nature of safeguards already in place. Part of the effectiveness of these safeguards is that they appropriately recognize the differing roles and relative access to customer information of an originating broker-dealer when contrasted with a recipient broker-dealer. Best execution obligations are complex and involve many factors, such as speed of execution, enhanced liquidity, and the possibility of price improvement; this fact was central to our deliberations and conclusions regarding the Proposed Rule.

We share the NASD's expressed concerns with alleged trading abuses by certain market participants. In this regard, we wish to work with NASD staff to find ways in which it can respond to these alleged abuses within the context of the current regulatory framework. We believe that this will achieve NASD's desired goal of enhanced investor protection, but without imposing onerous, previously unrecognized obligations on recipient broker-dealers to parties with whom they have no relationship and about whom they have limited information, relative to the routing broker-dealer.

B. Background on SR-NASD-2004-026

NASD proposes in the Proposed Rule filing to amend the current Best Execution Rule to require that a recipient member provide best execution to customer orders routed to it when there is either a written agreement between the originating broker-dealer and

⁴ See Letter to Barbara Z. Sweeney, Office of the Corporate Secretary, NASD, from George Jennison, SIA Trading Committee, and Christopher Franke, SIA Self-Regulation and Supervisory Practices Committee, dated September 9, 2002.

the recipient member or written representations from the recipient member that it will provide best execution to the originating broker-dealer's customer orders. The Proposed Rule change also would clarify that the originating broker-dealer (to the extent it is a member) remains obligated to comply with the Best Execution Rule, irrespective of whether such an agreement exists. Accordingly, an originating broker-dealer member must ensure its best execution obligations to its customers are met, and cannot rely on a written agreement or written representation as a safe harbor.

NASD states in the Proposed Rule that it expects that the existence of such a written agreement or representation from a recipient broker-dealer will be a significant factor in determining whether the originating broker-dealer member has met its best execution obligations when routing customer orders. In addition, there is a strong presumption that, as part of its Rule 2320 best execution obligations, an originating broker-dealer member must seek to obtain a written agreement that expressly states that the recipient broker-dealer will provide the originating broker-dealer's customers with best execution when the originating broker-dealer member has discretion to route the customers' order flow to a recipient broker-dealer (*i.e.*, non-directed orders) and does so on a regular basis.

C. SIA continues to support the positions expressed in its September 2002 Comment Letter on NTM 02-40, and accordingly believes that the amendments proposed in SR-NASD-2004-026 are unnecessary

In its September 2002 Comment Letter, the SIA expressed the view that clarification or extension of the scope of the duty of best execution is unnecessary and inappropriate. The Committee supports this position, and the underlying reasons articulated in that letter. Those reasons, along with certain additional ones, also support the present view that the Proposed Rule is unnecessary. These arguments are set forth below.

1. *Effective Investor Safeguards and Practices Already in Place*

SIA member firms believe that there are effective safeguards already in place and, as such, there is no need for modification of the Best Execution Rule or for written agreements or representations between an originating broker-dealer and an executing broker-dealer. Routing broker-dealers are currently obligated to provide best execution protection to their customers' orders, whether those orders are executed internally or routed to another broker-dealer. The vast majority of firms takes their best execution obligations very seriously and, as an important component of those obligations, regularly and rigorously examines the quality of executions received from both internal market making desks and from recipient broker-dealers who may execute orders on their behalf.

Recipient broker-dealers must provide executions of sufficiently high quality so as to allow the routing broker-dealer to fulfill its best execution obligations to its customers' orders. A recipient broker-dealer's failure to consistently provide such high quality

executions would almost certainly require a routing broker-dealer, in performance of its best execution obligations to its customers, to route its orders to another executing broker-dealer. Recipient broker-dealers that fail to give their best execution obligations sufficient focus also would be subject to NASD disciplinary action under the current regulatory framework. In addition to the regulatory structure currently in place, and as we first observed in our September 2002 Comment Letter, recipient broker-dealers have another significant incentive to provide quality executions — the very existence of their business depends on providing executions of sufficiently high quality to allow routing or originating broker-dealers to use their execution services without violating their best execution obligations. In those cases in which a routing broker-dealer questions the quality of an execution, the routing broker-dealer will generally request a price adjustment. The recipient broker-dealer typically will comply to avoid risking the loss of business from the routing broker-dealer.

2. *NASD Has At Its Current Disposal Effective Regulatory Tools That Accurately Reflect the Relative Positions of Routing and Recipient Broker-Dealers*

We believe that the Proposed Rule is unnecessary to secure jurisdiction over a recipient broker-dealer engaged in alleged trading abuses. The NASD already has several, effective enforcement tools at its disposal. In addition, sufficient recourse already exists for all parties if they believe that they did not receive best execution. Customers have remedies against their broker-dealers, and routing broker-dealers against recipient broker-dealers. For example, there are many existing rules that work together with the current Best Execution Rule in a comprehensive program that provides effective protection for all customer orders. These rules include:

- SEC Rule 11Ac1-1 (the "Quote" and "Firm Quote" Rules);
- SEC Rule 11Ac1-4 (the "Limit Order Display Rule");
- the transaction and order routing disclosure obligations under SEC Rules 11Ac1-5⁵ and 11Ac1-6;
- the anti-fraud provisions of SEC Rule 10b-5;
- NASD Rule 2110 ("Just and Equitable Principles of Trade");
- NASD Rule 2110-2 ("Manning") and proposed NASD Rule 2111 (which would extend *Manning* protections to customer market orders);
- NASD Rule 2120 ("Use of Manipulative, Deceptive or Other Fraudulent Devices"); and
- NASD Rules 4600 et seq ("Nasdaq Market Maker Requirements").

⁵ The reports required pursuant to Rule 11Ac1-5 provide an effective means for routing firms to make informed comparisons of execution quality among potential execution destinations, as well as for recipient firms to compare their own executions against those of competitors.

It is our view that these regulations can and do provide an effective safeguard against trading abuses in a manner that accurately recognizes the relative positions of routing and recipient broker-dealers with regard to customer orders. In contrast, the Proposed Rule would effectively juxtapose the roles of those parties, disadvantaging not only the recipient broker-dealer (in its attempt to glean an otherwise unrelated customer's best execution expectations) but, by extension, that customer as well (in terms of orders executed with imperfect customer information).

We understand, however, that the NASD believes that the current construction of the Best Execution Rule presents litigation challenges. Certain market participants engaged in allegedly abusive practices apparently have maintained that, in executing orders for another broker-dealer, they did not violate the Best Execution Rule, strictly on the basis that the transaction was not "for or with a customer." In our view, however, the most effective way for NASD to instill better behavior into the order execution process is by disciplining recalcitrant firms using the current regulatory tools at NASD's disposal (such as pursuant to a claim of "just and equitable principles"), not by enacting a rule that effectively misplaces obligations that should rightly reside with the routing broker-dealer.

3. *The Agreements Contemplated by the Proposed Rule Do Not Put The Recipient Broker-Dealer in a Position to Comply With a Best Execution Obligation to the Routing Broker-Dealer's Customer and Would be an Unjustified Administrative and Cost Burden*

The Committee believes that written agreements or representations are not an effective solution to the more fundamental issue of where the best execution obligation should properly reside. Such agreements and representations do not recognize the relative roles of routing and recipient broker-dealers and the general disparity in customer information at their disposal. A recipient broker-dealer, absent the availability of such customer information, would be in a relatively poor position to determine and provide best execution to the customer. As such, ascribing the best execution obligation to a recipient broker-dealer would necessitate the production of detailed information regarding the client that the routing broker-dealer, for various reasons, would likely be unwilling or unable to produce. As mentioned earlier, we believe that the current obligation of an originating broker-dealer to regularly and rigorously review the quality of executions provided by a recipient broker-dealer, in conjunction with the availability of Rule 11Ac1-5 data to support such a review, more accurately recognizes that routing broker-dealers are in a better position to ensure that their customers' orders are executed in a manner consistent with best execution principles. In addition, the Committee believes that the use of written agreements or representations would create significant administrative burdens and costs for broker-dealers, without real or incremental benefits for investors.

4. *Amendments Raise Privity Concerns*

The Committee is concerned that the language of the Proposed Rule could be mistakenly interpreted as creating privity between the recipient broker-dealer and the customer of the originating broker-dealer. We believe that the best execution obligation owed to the customer must reside with the originating broker-dealer, as the party that knows the customer. The recipient broker-dealer frequently does not know the customer and, as such, is at a significant disadvantage when attempting to gauge that customer's expectation of best execution (*e.g.*, does the customer value timely execution over price improvement?). As a result, we believe that imposing a regulatory requirement of best execution on the recipient broker-dealer would be unwarranted as it would unfairly require them to undertake an obligation, the satisfaction of which is almost wholly dependent upon having accurate and complete information on the party to whom the obligation is owed.

5. *Amendments Raise Anti-Competitive Concerns*

The Committee also has serious concerns about the potential anti-competitive effects of the rule. As written, the Proposed Rule requires the originating broker-dealer member to seek a written agreement from a recipient broker-dealer, but makes no reference to other recipient executing market centers. When a broker-dealer routes orders to a market center, such as a primary listing exchange, the broker-dealer does not obtain an agreement requiring best execution from that market center. When a broker-dealer receives an order from another broker dealer, the receiving broker-dealer is functioning in its capacity as a market center. From a regulatory parity perspective, it does not make sense to require a best execution undertaking from one market center and not another. Doing so would create an unlevel playing field for NASD member firms versus other market centers such as specialists and exchanges.

6. *Amendments May Reduce Execution Options*

Finally, the Committee believes that the imposition of these written agreements may have a "chilling effect" on many broker-dealers that currently accept and execute routed orders. Unlike those broker-dealers the primary business of which is to accept routed orders for execution, some broker-dealers currently accept and execute routed orders in only specific securities, in specific market sectors, or from broker-dealers with which they have an on-going relationship. The potential regulatory and civil liability emanating from these agreements or representations, in addition to the resulting administrative burdens, may cause those broker-dealers that execute routed orders other than as a core business to withdraw from this business. The Committee believes that this would reduce the number of execution options available to routing broker-dealers and significantly diminish competition for this order flow to the ultimate detriment of retail customers.

D. If NASD is to go forward with this proposal, we strongly recommend the following amendments and clarifications

As stated above, it is our desire to work with the NASD to resolve alleged market abuses without the imposition of new regulations that, in our view, will lead to an incorrect result. As such, and absent our preferred position of withdrawal of the Proposed Rule, we offer for consideration the following recommendations. We note that these are not exclusive recommendations, and we welcome the opportunity to discuss these or other alternatives with the NASD staff.

1. *Proposal to Eliminate the Written Agreement/Representation Provision and Modify the Proposed Rule*

Based in part on suggestions previously received from NASD, we suggest that proposed sections (a)(1)(E) and (a)(2) of the Proposed Rule could be deleted and the following modifications to the Proposed Rule could be made (*possible new language in italics*):

(a)(1) In any transaction for or with a customer *or the customer of another broker or dealer*, a member and persons associated with a member shall use reasonable diligence to . . .

(a)(2) *For purposes of subparagraph (a)(1), a broker-dealer that receives an order ("recipient member") from a broker-dealer originating an order ("originating broker-dealer") will be deemed to have satisfied its best execution obligation if it executes the order in accordance with the terms and conditions of such order, as communicated by the originating broker-dealer. Nothing in this subparagraph (a)(2) changes the application of subparagraph (a)(1) to an originating broker-dealer member with respect to such order or requires a recipient member to accept an order from any customer or broker-dealer.*

The Committee believes it is inappropriate, both from a legal and policy perspective, to expand a broker-dealer's obligations to parties with whom the broker-dealer has no contractual relationship. Best execution obligations appropriately reside with the broker-dealer that knows the customer (*i.e.*, the originating broker-dealer). The recipient broker-dealer usually does not know the customer and, even with the existence of a written agreement or representation, the recipient broker-dealer would remain relatively unfamiliar with the customer's expectation of best execution.⁶ The Rule

⁶ At least one firm notes that the alternative proposal recognizes the basic legal principles that have long governed the making of oral contracts for the purchase or sale of securities and looks to the agreement created by the acceptance of each of the respective orders and subsequent performance of the parties. The terms and conditions, which form the obligations of the parties to the separate but related contracts, are required to be separately recorded under SEC Rule 17a-3(a)(6) and (7). This simple and well-established legal structure works in all but some of the most heavily fact dependent and isolated circumstances. Rules of general application are never able to address isolated and fact dependent situations and to do so is a

Proposal, if adopted in its current form, would expand a broker-dealer's duty of best execution to parties with whom the broker-dealer has no contractual relationship and no way of knowing what that party's execution priorities might be. Consequently, misunderstandings and disputes will ultimately arise when a recipient broker-dealer makes any reasonable assumption as to what unrelated "customers" would consider to be best execution. We believe that the practical consequence of this may be that the price at which an order was executed may effectively become the sole determinant of best execution. In our view, and we would speculate in the NASD's view as well, this would be entirely the wrong result.⁷

It is therefore important that the NASD clarify that the Proposed Rule does not create privity between the customer of the routing broker-dealer and the recipient broker-dealer, and therein impose a general best execution obligation on the recipient broker-dealer. If the NASD determines that the amendments are necessary, we respectfully urge that its application be limited to allow a recipient broker-dealer to rely on the terms of the order received from the routing broker-dealer (in lieu of a more extensive knowledge of the actual customer) to fulfill its duty of best execution. Additionally, the SIA recommends that the NASD clarify that nothing in this rule proposal requires any broker-dealer to accept any order from any customer or broker-dealer (*i.e.*, broker-dealers should retain the discretion to reject any order).

We note that several recent rule filings address order handling and how firms must treat "customers of their customers."⁸ We believe that it is imperative that the industry address this issue comprehensively. Customers should not have recourse against recipient broker-dealers with which they have no privity of contract. We strongly believe that duties to such customers should be narrowly construed as discussed above.

2. *Recipient Broker-Dealer and Originating Broker-Dealer Should Be Free to Negotiate Specific Order Handling Terms*

The NASD should clarify in the Proposed Rule change that there is nothing that precludes a recipient broker-dealer from negotiating with a routing broker-dealer any specific order handling terms (*e.g.*, auto execution up to a certain quantity) or other conditions. Moreover, such obligations could be derived from, and measured against, the

disservice to the markets and investors alike. Therefore, the proposed alternative in this letter is a better solution, in that the existing contract making process does not create or even suggest an extended privity like NASD's Proposed Rule.

⁷ As both current Rule 2320 and the Proposed Rule make clear, price is but one among many factors to consider when determining whether a member has provided an order with best execution.

⁸ *See, e.g.*, SR-NASD-2004-089 (Proposed Amendments to Require Price Improvement to Limit Orders in Certain Circumstances) and SR-NASD-2004-045 (Proposed Rule Change to Prohibit a Member from Trading Ahead of a Customer Market Order and to Require the Crossing of Customer Market Orders under Certain Circumstances).

express terms of the order (*e.g.*, if the recipient broker-dealer agrees to best execution obligations such as speed, price, etc., then that would be defined by the terms of the order, which could be expressed on an order ticket, in a written agreement, or in another formal or informal arrangement if the parties so choose).

3. *NASD Should Limit Application of the Rule Proposal to Established, Transparent Markets*

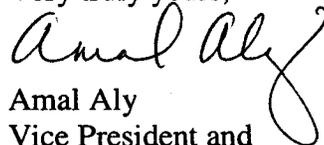
If NASD and SEC determine to proceed with the Proposed Rule, it is essential that its application be limited to established, transparent markets (*e.g.*, Nasdaq stocks) and that it not be applied in those markets where there is no real-time trade reporting nor a disseminated NBBO. With regard to the bond markets, we would advocate a similar analysis but defer to The Bond Market Association to express detailed concerns or recommendations in this area.

E. Conclusion

For the reasons stated herein, we reiterate our view that the best solution is for the NASD to simply withdraw the Proposed Rule entirely and to address any possible trading abuses by certain broker-dealers with existing enforcement tools at its disposal.

Thank you for taking the time to consider our views on this important rule proposal. We would appreciate the opportunity to continue this dialogue with the NASD staff. If you have any questions, you may contact the undersigned at 212-608-1500 or 202-216-2000.

Very truly yours,



Amal Aly
Vice President and
Associate General Counsel



Ann Vlcek
Vice President and
Associate General Counsel

cc: Mary L. Schapiro, Vice Chairman
Marc Menchel, Executive Vice President and General Counsel
Steve Luparello, Executive Vice President
Thomas R. Gira, Senior Vice President
Richard Wallace, Vice President
Kathleen O'Mara, Assistant General Counsel

EXHIBIT 4

Below is the text of the proposed rule change marked to indicate additions and deletions from the text as proposed on May 11, 2004 in Amendment No. 1. Proposed new language is double-underlined; proposed new deletions are in bold brackets. Previously proposed new language is underlined; previously proposed deletions are in brackets. Previously proposed changes that are no longer being sought are crossed out.

* * * * *

2300. TRANSACTIONS WITH CUSTOMERS

* * * * *

2320. Best Execution and Interpositioning

(a)~~(1)~~ In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best [inter-dealer] market center for the subject security and buy or sell in such market center so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

{(1)}~~(A)~~ [T]the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;

{(2)}~~(B)~~ the size and type of transaction;

{(3)}~~(C)~~ the number of [primary] market[s] centers checked;

{(4)}~~(D)~~ accessibility of the quotation[the location and accessibility to the customer’s broker/dealer of primary markets centers and quotations sources][.]; and

(5) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

(E) with respect to customer orders that are routed to another broker-dealer for handling and/or execution, the existence of a written agreement or written representation that the customer will receive best execution.

(2) For purposes of subparagraph (a)(1) only, the term “customer” also shall include a customer of a broker/dealer that originates an order on behalf of the customer (the “originating broker/dealer”) and directs it to a member (the “recipient member”), provided there is a written agreement between the originating broker/dealer and the recipient member or written representations from the recipient member that the recipient member and persons associated with the recipient member will provide best execution to such order in conformity with subparagraph (a)(1). Nothing in this subparagraph (a)(2) changes the originating broker/dealer’s obligation to comply with subparagraph (a)(1) with respect to such order.

(b) through (g) No change.

* * * * *